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C O N F I D E N T I A L SECTION 01 OF 03 BEIJING 003775

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STATE FOR EAP/CM -- PARK AND FLATT
STATE FOR EEB/OIA -- SCHOLZ, TRACTON, AND HICKS
STATE FOR E -- YON
STATE PASS USTR FOR STRATFORD, WINTER, BAHAR, AND KATZ
STATE PASS FTC FOR GENERAL COUNCIL BLUMENTHAL AND KALLAY
STATE PASS TDA FOR JACKSON
DOJ FOR DAAG O'CONNELL AND CHEMTOB
NSC FOR DNSA PRICE, SMART, AND LOI

E.O. 12958: DECL: 09/28/2018
TAGS: EAID ECON EFIN CH
SUBJECT: Coca-Cola's Huiyuan Bid Illustrates BIT Challenges, AML Implementation Problems

Classified By: Econ Minister-Counselor Robert Luke for Reasons 1.4 (b) and (d)

¶1. (C) Summary. Coca-Cola Pacific Deputy Group President Paul Etchells briefed Acting Economic Minister-Counselor 9/17 on Coke's proposed acquisition of a leading Chinese juice maker for US$2.4 billion. Coke, which agreed to the meeting at our request, emphasized that it is not seeking U.S. Government assistance and does not want it to become public that it had met Embassy staff. Coca-Cola is cautiously optimistic China will approve the transaction, speculating that Ministry of Commerce (MOFCOM) officials will not want to be seen blocking the first big foreign transaction filed under the Anti-Monopoly Law (AML), especially one that minimally affects competition and is unrelated to China's security. Comment: Coca-Cola may not fully appreciate the risks that the transaction could become politicized. The case is an important test of China's use of the AML. The proposed deal also concretely illustrates China's convoluted foreign investment review process, thus providing an on-the-ground perspective relevant to ongoing U.S.-China Bilateral Investment Treaty (BIT) negotiations. End Summary.

The Deal's Legal Structure

¶2. (SBU) Etchells said Coca-Cola had received legally irrevocable backing for the transaction from Huiyuan's four largest shareholders - the company's Chinese founder, French beverage group Danone, Warburg Pinkus, and Fidelity - who collectively control 70% of Huiyuan's stock. The other 30% of Huiyuan's shares are listed on the Hong Kong stock exchange. The proposed transaction price represents a 200% premium to the firms' market value. The contract is dependent upon China approving the transaction within 200 days, a deadline that can be extended if all parties to the transaction agree. (Note: AML implementing regulations allow China 30 days to review transactions, plus 150 days to conduct more intensive reviews, if needed. End Note.) Coke said it had never before acquired a firm of Huiyuan's size in China.

Coke Cautiously Optimistic

¶3. (SBU) Coca-Cola was cautiously optimistic that the deal would be approved. MOFCOM would not want to block the first transaction filed

under the AML when competitive and security concerns were both minimal, Etchells opined. Coca-Cola said that the best, independent data, provided by a firm called "Canadian," showed that Coca-Cola and Huiyuan would have a combined share slightly exceeding 20% of the non-alcoholic beverage market and slightly less than 20% of the juice market. Coca-Cola currently has a miniscule share of the juice market in China, so its acquisition of Huiyuan would not meaningfully impact concentration in that sector. Besides market share, Coca-Cola noted that large grocery chains have countervailing bargaining power and that the beverage sector has low barriers to entry, an analysis it had shared with MOFCOM. Coca-Cola had heard informally that MOFCOM planned to take a "market-based view" of the transaction. Earlier conversations with a MOFCOM-affiliated think tank support Coke's assumption that MOFCOM would take such a view. Also, working in Coca-Cola's favor, China's Guidance Catalogue for Foreign Investment lists "fruit drinks" as a sector where foreign investment is "encouraged."

Roles of MOFCOM, NDRC, and Other Agencies

¶4. (SBU) Regarding China's approval of the transaction, Etchells said MOFCOM appears to be playing the leading role. Coca-Cola had met with MOFCOM anti-trust staff after announcing the deal and planned to formally file paperwork with MOFCOM's anti-trust office on September ¶18. Coca-Cola's lawyers have advised that Coke does not need to file with any other agencies. Etchells assessed that the National Development and Reform Commission (NDRC) likely would not pay attention to the deal because it was so obviously not a national security issue. Etchells sai Coca-Cola had not lobbied high-level Chinese fficials before announcing the deal, and since hen, had met

only MOFCOM working-level staff.

¶5. (SBU) Comment: Other agencies certainly will also play roles. MOFCOM has told us separately that, in addition to internally reviewing foreign mergers and acquisitions (M&A), it also disseminates filings to other "relevant" agencies for "pre-approval." In addition, NDRC Vice Minister Zhang Xiaoqiang stated at the first U.S.-China Investment Forum in June 2008 that NDRC heads up China's inward investment approval process. According to NDRC, any cross-border M&A transactions that would lead to additional investment in the operations of the acquired firm require separate approval under China's "investment approval process," which is distinct from the "M&A approval." In typical cases, the approval of a sector regulator, such as the Ministry of Industry and Information, is also required. For transactions that China believes impact its "national security," an ad hoc interagency committee also reviews deals. (Note: China is in the process of formalizing this national security review. End Note.) M&A transactions also require an updated business license for the new, combined firm, issued by the State Administration of Industry and Commerce, the same agency that separately investigates abuse of market dominance under the AML. Finally, all foreign transactions that result in the transfer of state-owned assets -- which is not the case here -- require approval by the State Council. End Comment.

Coke Uncertain Which Reviews MOFCOM is Conducting
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¶6. (SBU) Regarding MOFCOM's review, Coca-Cola troublingly was unaware whether MOFCOM would evaluate the transaction solely under China's new AML, for its competitive effects. Etchells said Coca-Cola did not know whether "interim" regulations issued by MOFCOM and six other agencies in August 2006 which, under Article 13, require a acquirers to notify MOFCOM of transactions that would transfer control of a famous Chinese trademark, time-honored Chinese brand, and transactions that impact China's "national economic security" would be the basis for a separate review.

¶7. (SBU) Note: When China released the 2006 rules, MOFCOM officials told us that their antitrust provisions were a "placeholder" describing MOFCOM's review of foreign M&A until China passed an AML. It is not clear if the AML's subsequent release invalidates the requirement that foreign parties notify MOFCOM of transactions

affecting trademarks, brands, and thus whether there remains a separate review. In any case, apart from the antitrust review, MOFCOM never publicly released standards guiding its evaluation of transactions filed because they transferred control of famous trademarks or brands, or impacted national economic security. As a result, foreign firms may not know if they are being reviewed, as is the case here. End Note.

China's Review of Trademark and Brand Acquisitions
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¶8. (SBU) Etchells said Coca-Cola believes China likely will not examine the effect of the transaction on the Huiyuan brand or its trademarks. Coke assessed that the reference to famous trademarks and time-honored brands in the 2006 regulations refers to products pre-dating China's economic reform; that is, products in which the State had invested development capital or products reflecting China's traditional culture. For example, Etchells said that the popular Chinese tea-based beverage drink "Wanglaoji" was an old brand with state-owned industry ties. He added that Coca-Cola had at one point "looked at . . . Tong Ren Tang" a well-known, old beverage brand that uses traditional ingredients, and was advised that the state would not allow the brand to fall into foreign hands. Etchells noted that the Coca-Cola brand pre-dates Huiyuan in China. He dismissed Chinese press reports cautioning that Coca-Cola would plan to "kill off" the Huiyuan brand, as any such move would force Coca-Cola to recognize an accounting loss on the goodwill it acquires in the transaction.

Role of Industry Association, Competitors

¶9. (SBU) Etchells added that Coca-Cola expects MOFCOM will consult

with the Chinese Beverage Industry Association (CBIA) on the competitive effects of the transaction. Coca-Cola has lobbied CBIA to remain impartial. One potential problem was that MOFCOM could base its evaluation of the transaction's competitive effects on less reliable CBIA data. If that were the case, CBIA and MOFCOM may not share the data with Coca-Cola, making it difficult to rebut. Coca-Cola assessed that while competing firms had expressed their opposition to the deal and reportedly lobbied MOFCOM, that this behavior was not unique to China.

Coke Discounts Public Opposition to the Deal

¶10. (SBU) Coca-Cola was skeptical of reported public outcry against the deal, illustrated by a widely cited Sina.com online poll which showed that up to 80% of respondent's opposed the transaction. Participants in the Sina.com poll were a self-selecting group, Coke said. Net traffic on the topic had also fallen off, especially as the number of stories on tainted milk had ballooned. Chinese print media had been reasonably balanced. Coca-Cola was working on background to correct inaccurate initial reporting on the combined firms' market shares.

Market Culture Has Not Fully Entered the "Public Psyche"
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¶11. (SBU) Most troubling to Coca-Cola was the vitriolic reaction on the internet to news that Huiyuan's founder stood to clear $1 billion by selling the firm. The founder must have found the reaction distressing and has come under some pressure not to sell. Etchells observed that Chinese people seemed to be "incompletely tuned into capitalism." While they widely acknowledged that a person had the freedom to start up a company and conduct business, when it came time to sell, there was still a public perception that the asset was somehow collectively owned. The idea of freely disposing of assets, which would allow entrepreneurs to use their gains to start new firms, had not yet entered the public psyche, he said.

Comment -- Transaction Could Become Politicized
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¶12. (C) Coca-Cola may not fully appreciate the range of problems the

proposed transaction could encounter. The acquisition touches a number of hot button issues, including China's intention to secure a more self-sufficient domestic food supply, its desire to develop and protect domestic brands, and the lack of transparency in China's multiple and overlapping inward foreign investment reviews. In these circumstances, the proposed transaction will be a clear and important test of MOFCOM's repeated assurances that it will evaluate AML filings from a "market-based perspective," as well as the utility and accurateness of the foreign investment catalogue, which "encourages" foreign investment in "juice drink manufacturing." Coke's uncertainty about which filing requirements apply to the case and which ones it has met, which agencies are reviewing the deal, and the standards those agencies are using are a concrete illustration of the challenges U.S. businesses face when they seek to acquire big Chinese companies.